Cash, Fraud, and Internal Control

Chapter 8

Wild and Shaw

Fundamental Accounting Principles

25th Edition

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Chapter 8 Learning Objectives

CONCEPTUAL

C1 Define internal control and identify its purpose and principles.

C2 Define cash and cash equivalents and explain how to report them.

ANALYTICAL

A1 Compute the days' sales uncollected ratio and use it to assess liquidity.

PROCEDURAL

P1 Apply internal control to cash receipts and payments.

P2 Explain and record petty cash fund transactions.

P3 Prepare a bank reconciliation.

P4 *Appendix 8A* – Describe use of documentation and verification to control cash payments.

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Learning Objective C1

Define internal control and identify its purpose and principles.

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Internal Control System

An internal control system is used to monitor and control business activities. It includes the policies and procedures used to:

- Protect assets.
- Ensure reliable accounting.
- Uphold company policies.
- Promote efficient operations.

Learning Objective C1: Define internal control and identify its purpose and principles.

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Sarbanes-Oxley Act (SOX)

The Sarbanes-Oxley Act requires managers and auditors of public companies to document and certify the system of internal controls.

Requirements include:

- The company must have effective internal controls.
- Auditors must evaluate internal controls.
- Violators receive harsh penalties up to 25 years in prison with fines.
- Auditors' work is overseen by *Public Company Accounting Oversight Board* (PCAOB).

Learning Objective C1: Define internal control and identify its purpose and principles.

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Committee of Sponsoring Organizations (COSO)

Committee of Sponsoring Organizations (COSO) lists five ingredients of internal control which add quality to accounting information:

1. Control environment
2. Risk assessment
3. Control activities
4. Information & communication
5. Monitoring

Learning Objective C1: Define internal control and identify its purpose and principles.

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Principles of Internal Control

Internal control principles common to all companies:

1. Establish responsibilities.
2. Maintain adequate records.
3. Insure assets and bond key employees.
4. Separate recordkeeping from custody of assets.
5. Divide responsibility for related transactions.
6. Apply technological controls.
7. Perform regular and independent reviews.

Learning Objective C1: Define internal control and identify its purpose and principles.

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Internal Control: Establish Responsibilities

1. Tasks should be clearly established.
2. Tasks should be assigned to one person.
3. Can then determine who is at fault.

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Internal Control: Maintain Adequate Records

1. Protects assets.
2. Helps managers monitor company activities.
3. Includes:
   1. Detailed records.
   2. Use of chart of accounts.
   3. Preprinted forms.
   4. Prenumbered sales slips.
   5. Computerized point-of-sale systems.

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Internal Control: Insure Assets and Bond Key Employees

1. Assets should be insured against losses.
2. Employees handling a lot of cash and other assets should be bonded.
3. Bonding means the company has purchased an insurance policy against theft by that employee.

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Internal Control: Separate Recordkeeping from Custody of Assets

1. Person who controls or has access to assets must not have access to that asset's accounting records.
2. Reduces risk of theft or waste of an asset.
3. Employees would need to collude, agree in secret, to commit fraud under this control.

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Internal Control: Divide Responsibility for Related Transactions

1. Responsibility for a transaction should be divided between two or more individuals.
2. Ensures work of one person acts as a check on the other to prevent fraud or errors.
3. Called separation of duties.

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Internal Control: Apply Technological Controls

1. Cash registers make an electronic file/record of each sale.
2. Time clock records exact time employee works.
3. ID scanners limit access to authorized individuals.

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Internal Control: Perform Regular and Independent Reviews

1. Helps ensure that procedures are followed.
2. Preferably done by auditors not directly involved in the activities.
3. Auditors evaluate the efficiency and effectiveness of internal controls.

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Technology, Fraud, and Internal Control

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Blockchain as a Control

Blockchain is a more secure type of accounting ledger which continuously and simultaneously updates and verifies the ledger.

1. Prevents modification without detailed record of changes.
2. Changes cannot be destroyed or hidden.
3. Auditors focus on testing the effectiveness of company's blockchain processes and technology.

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Limitations of Internal Control

Human Error
Carelessness
Misjudgment
Confusion

Human Fraud
Intentionally defeating internal controls for personal gain

Fraud Triangle: Opportunity, Pressure & Rationalization

Cost-benefit constraint: costs of internal controls must not exceed their benefits.

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Learning Objective C2

Define cash and cash equivalents and explain how to report them.

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Control of Cash

An effective system of internal control that protects cash and cash equivalents should meet three basic guidelines:

Handling cash is separate from recordkeeping for cash.

Cash receipts are promptly deposited in a bank.

Cash payments are made by check or EFT.

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Cash, Cash Equivalents, and Liquidity

Cash and similar assets are called liquid assets because they can be readily used to pay liabilities.

Cash

Currency, coins, and deposits in bank accounts. Also includes items such as customer checks, cashier checks, certified checks, and money orders.

Cash Equivalents

Short-term, highly liquid investments that are:

1. Readily convertible to a known cash amount.
2. Close to maturity date and not sensitive to changes.

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Cash Management

The goals of cash management are twofold:

1. Plan cash receipts to meet cash payments when due.
2. Keep a minimum level of cash necessary to operate.

Effective cash management involves applying the following cash management strategies:

- Encourage collection of receivables.
- Delay payment of liabilities.
- Keep only necessary assets.
- Plan expenditures.
- Invest excess cash.

Learning Objective C2: Define cash and cash equivalents and explain how to report them.

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Learning Objective P1

Apply internal control to cash receipts and payments.

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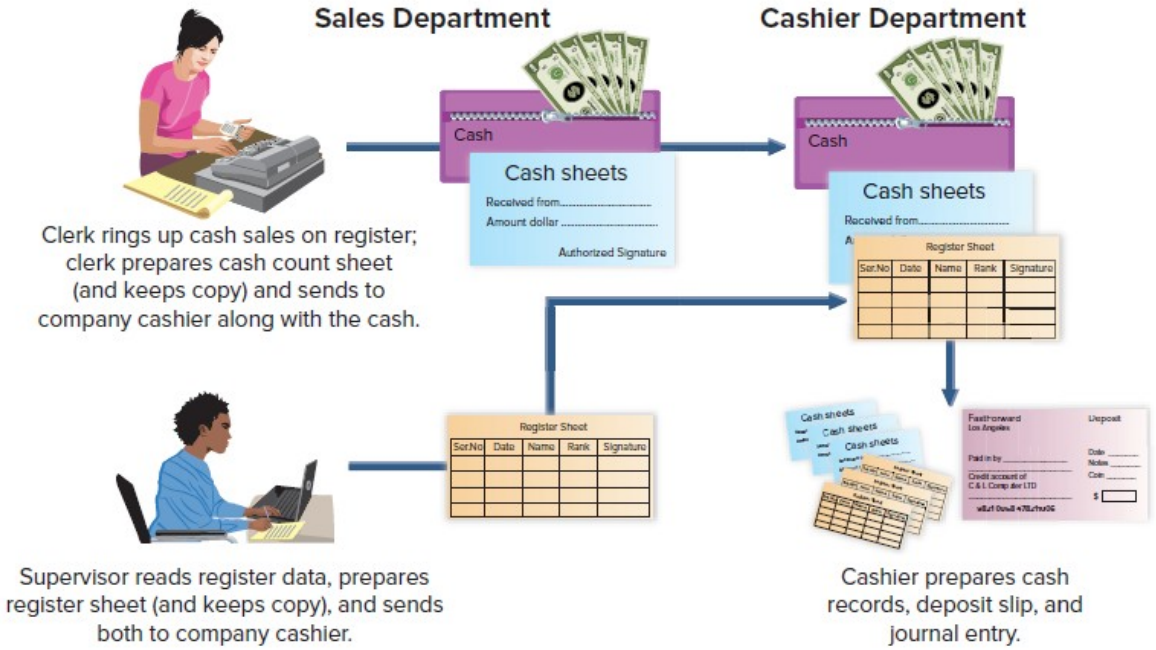
Over-the-Counter Cash Receipts

This graphic illustrates that none of the people involved can make a mistake or divert cash without the difference being revealed



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Cash Over and Short: Overage

Sometimes errors in making change are discovered from differences between the cash in the cash register and the record of the amount of cash receipts.

If a cash register's record shows $550 but the count of cash in the register is $555, we would prepare the following journal entry:

Cash	555	
Cash Over and Short		**5**
Sales		550
To record cash sales and a cash overage.		

Learning Objective P1: Apply internal control to cash receipts and payments.

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Cash Over and Short: Shortage

Sometimes errors in making change are discovered from differences between the cash in the cash register and the record of the amount of cash receipts.

On the other hand, if a cash register's record shows $625 but the count of cash in the register is $621, the entry to record cash sales and its shortage is:

Cash	621	
Cash Over and Short	**4**	
Sales		625
To record cash sales and a cash shortage.		

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Cash Receipts by Mail

Two people are assigned the task of opening the mail.

The cashier deposits the cash in a bank.

The recordkeeper records amounts received in the accounting records.

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Control of Cash Payments

Control of cash payments is important as most large thefts are from payment of fictitious invoices.

Keys to Controlling Cash Payments:

- Require all payments to be made by check.
- Limit access to accounting records except for those who have the authority to sign checks.

Cash Budget:

- Includes projected cash receipts and cash

Learning Objective P1: Apply internal control to cash receipts and payments.

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Voucher System of Control[1]

A voucher system establishes procedures for:

1. Verifying, approving, and recording liabilities for eventual cash payments.
2. Issuing checks for payment of verified, approved, and recorded liabilities.

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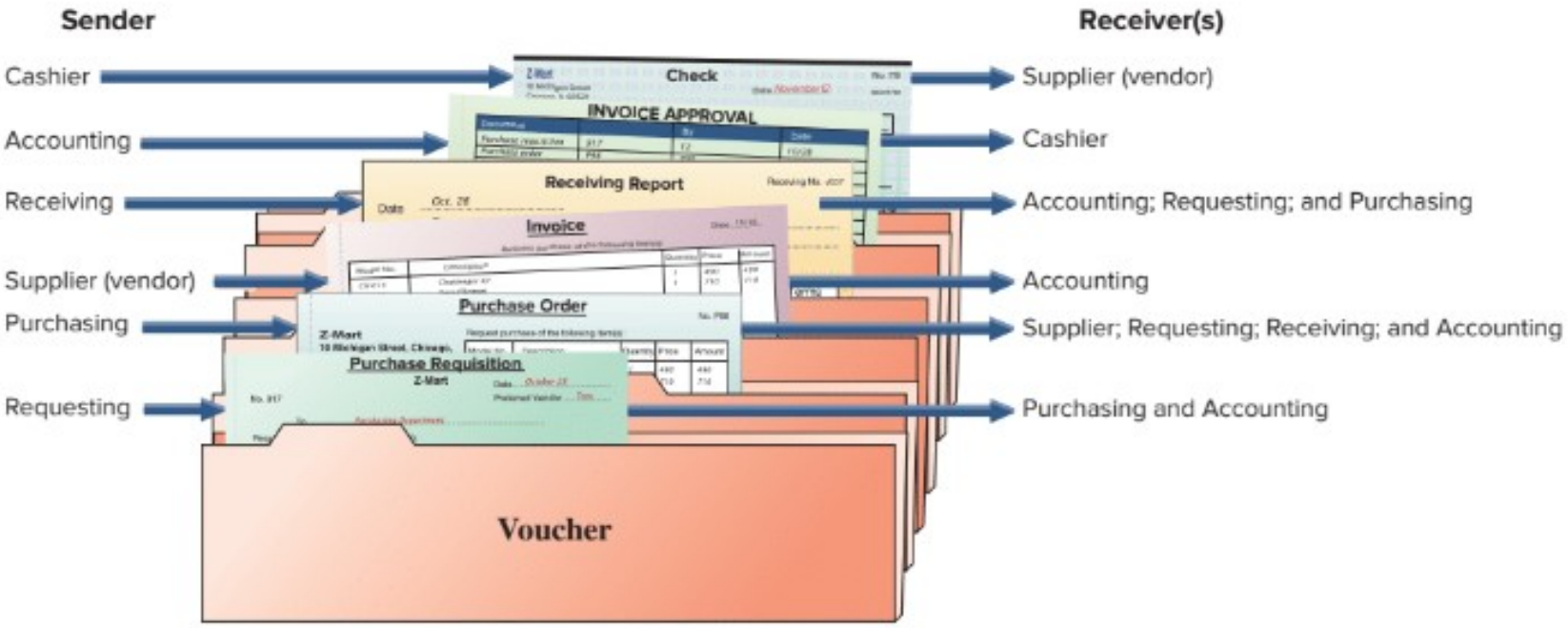
Voucher System of Control 2

Exhibit 8.1



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Learning Objective P2

Explain and record petty cash fund transactions.

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Petty Cash System of Control

Small payments for items such as:

- Shipping fees,
- Minor repairs, and
- Low-cost supplies.

Learning Objective P2: Explain and record petty cash fund transactions.

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Establishing a Petty Cash Fund

To establish a petty cash fund: Petty Cash is debited to increase Cash is credited to decrease

Nov. 1	Petty Cash	75	
	Cash		75
	Establish a petty cash fund.		

Learning Objective P2: Explain and record petty cash fund transactions.

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Operating a Petty Cash Fund

Summary of petty cash receipts:

Petty Cash Payments Report		
Merchandise Inventory (transportation-in)		
Nov. 5	Transport of merchandise purchased	$ 15.05
Office Supplies Expense		
Nov. 15	Purchase of office supplies immediately used	4.75
Delivery Expense		
Nov. 18	Customer's package delivered	5.00
Miscellaneous Expense		
Nov. 27	Tile cleaning	46.50
Total		**$71.30**

Exhibit 8.3

Lea
transactions.

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Reimbursement of Petty Cash Fund

The petty cash payments report is used in making the journal entry to reimburse the fund.

Debit each of the expenses, Merchandise Inventory and credit Cash.

Nov. 27	Merchandise Inventory	15.05
	Office Supplies Expense	4.75
	Delivery Expense	5.00
	Miscellaneous Expenses	46.50
	Cash*	71.30
	*Reimburse petty cash. * $75 fund bal. − $3.70 cash remaining.*	

Lear
transactions.

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Increasing or Decreasing a Petty Cash Fund

To increase, debit Petty Cash and credit Cash.

Nov. 27	Petty Cash	25
	Cash	25
	Increase petty cash fund amount from $75 to $100	

To decrease, debit Cash and credit Petty Cash.

Nov. 27	Cash	20
	Petty Cash	20
	Decrease petty cash fund amount from $75 to $55.	

Learning
transactions.

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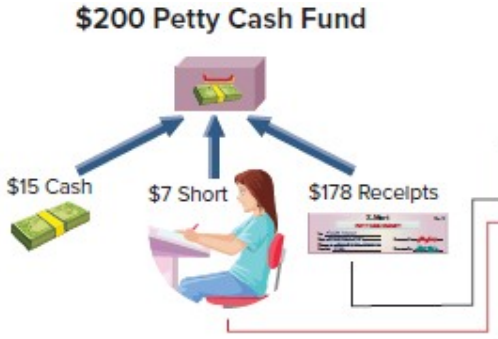
Cash Over and Short

- If petty cashier fails to obtain a receipt for payment or overpays an amount, cash over or short will result.
- Petty cash payments report plus cash left in account will not total to the fund balance.
- Shortage: difference is debited to Cash Over and Short.
- Overage: difference is credited to Cash Over and Short.



June 1	Miscellaneous Expenses	178	
	Cash Over and Short	7	
	Cash*		185
	Reimburse petty cash. **$200 fund bal. – $15 cash remaining.*		

Learning Objective P2: Explain and record petty cash fund transactions.

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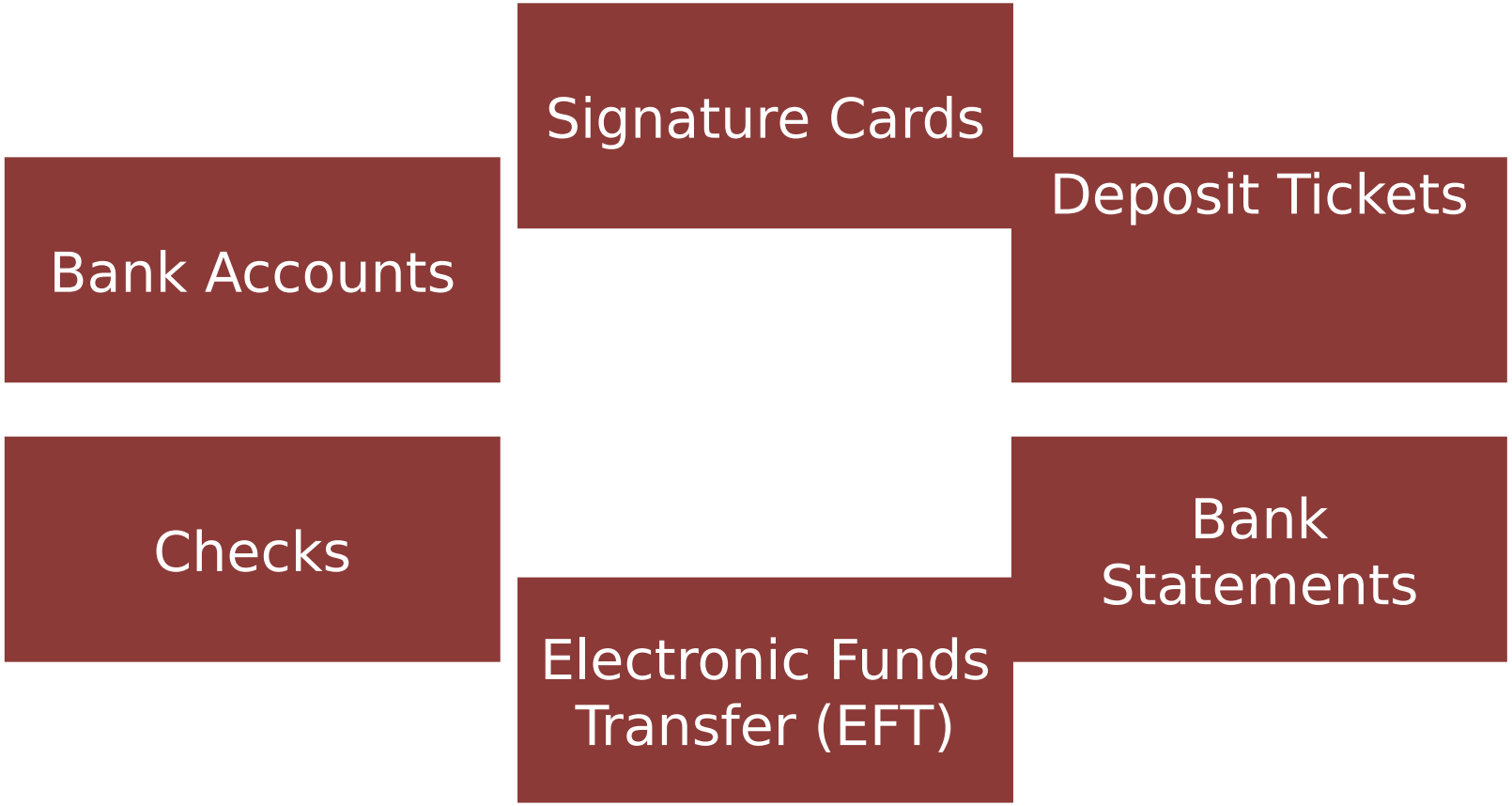
Basic Bank Services



Learning Objective P2: Explain and record petty cash fund transactions.

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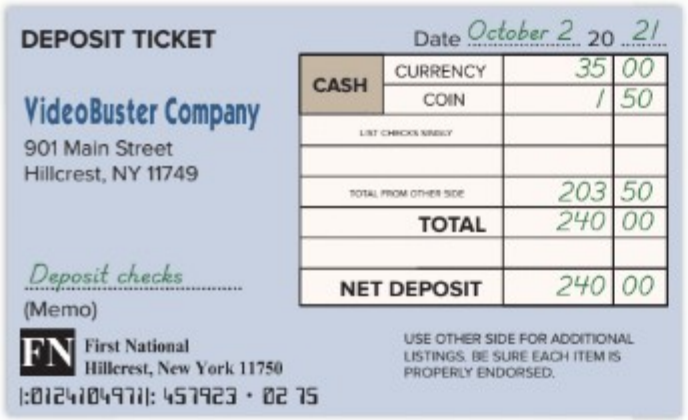
Deposit Ticket

1. Used to deposit money in the bank.
2. Lists cash and checks along with the amounts.

Front



Back

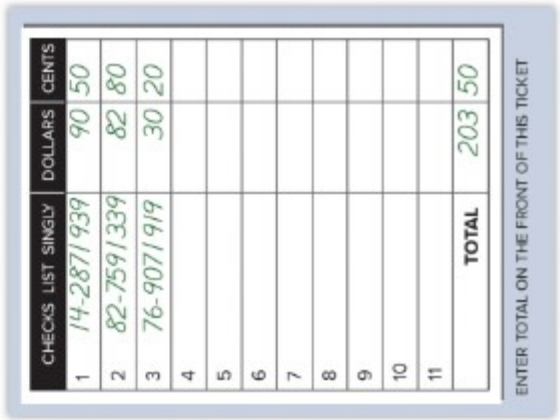


Exhibit 8.4

Learning Objective P2: Explain and record petty cash fund transactions.

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Check

1. Used to withdraw money from the bank.
2. Includes maker, signor of check; payee; and payer.

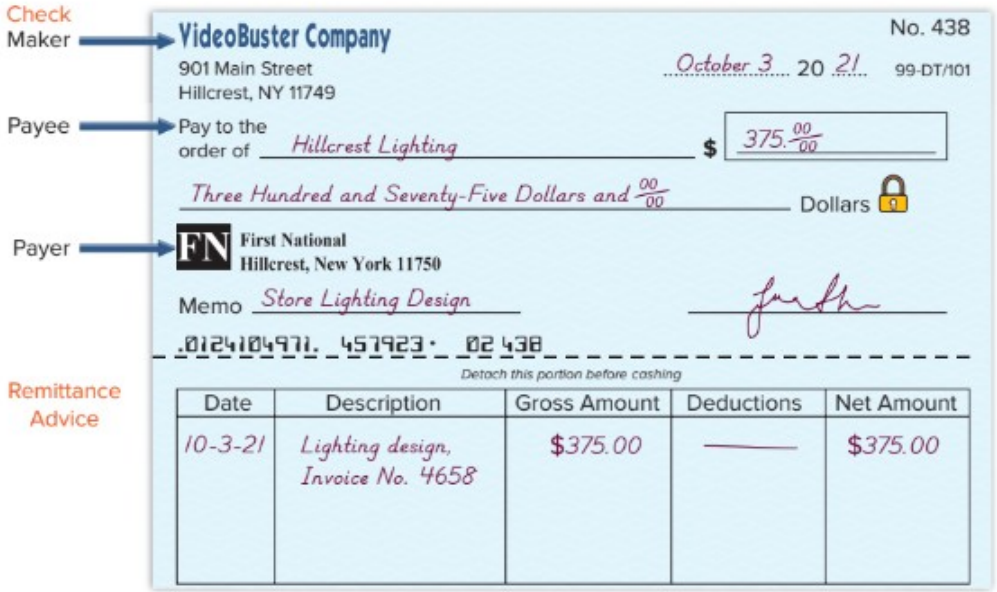

Exhibit 8.5

Learning Objective P2: Explain and record petty cash fund transactions.

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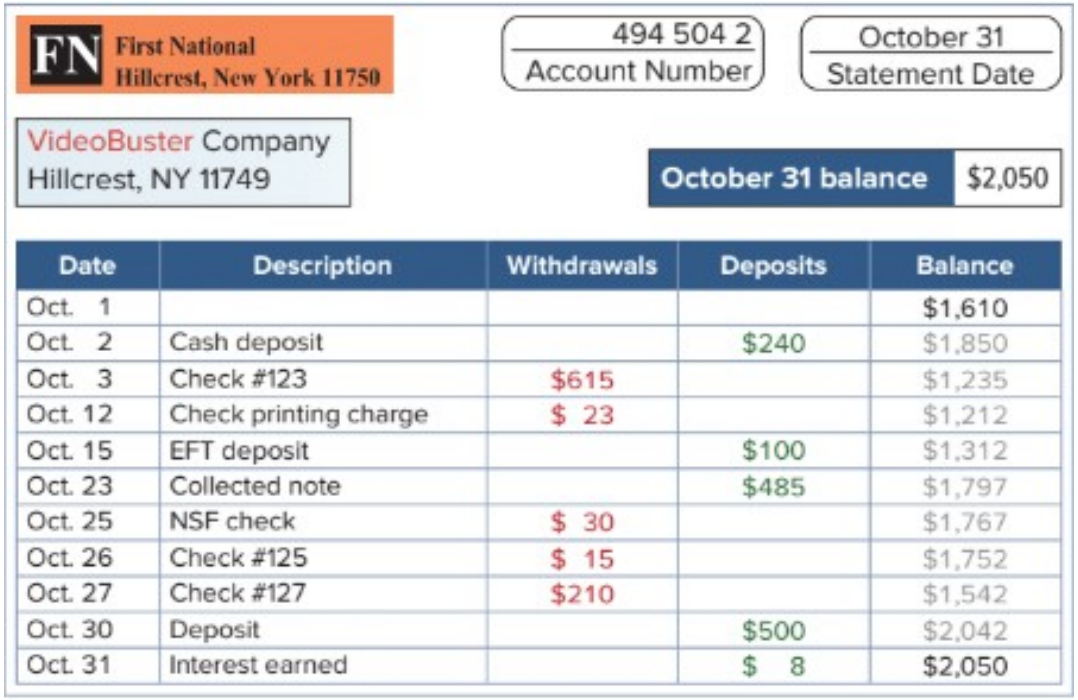
Bank Statement

Exhibit 8.6



FN First National Hillcrest, New York 11750

494 504 2 — Account Number

October 31 — Statement Date

VideoBuster Company
Hillcrest, NY 11749

October 31 balance	$2,050

Date	Description	Withdrawals	Deposits	Balance
Oct. 1				$1,610
Oct. 2	Cash deposit		$240	$1,850
Oct. 3	Check #123	$615		$1,235
Oct. 12	Check printing charge	$ 23		$1,212
Oct. 15	EFT deposit		$100	$1,312
Oct. 23	Collected note		$485	$1,797
Oct. 25	NSF check	$ 30		$1,767
Oct. 26	Check #125	$ 15		$1,752
Oct. 27	Check #127	$210		$1,542
Oct. 30	Deposit		$500	$2,042
Oct. 31	Interest earned		$ 8	$2,050

Usually once a month, the bank sends each depositor a bank statement showing the activity in the account.

Learning Objective P2: Explain and record petty cash fund transactions.

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Learning Objective P3

Prepare a bank reconciliation.

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Bank Reconciliation

A bank reconciliation is prepared periodically to explain the difference between cash reported on the bank statement and the cash balance on company's books.

Bank Balance Adjustments	Book Balance Adjustments
Add deposits in transit.	Add interest earned and unrecorded cash receipts.
Subtract outstanding checks.	Subtract bank fees and NSF checks.
Add or subtract corrections of bank errors.	Add or subtract corrections of book errors.

Learning Objective P3: Prepare a bank reconciliation.

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Purpose of Bank Reconciliation

The balance of a checking account reported on the bank statement rarely equals the balance in the depositor's

Cash Balance per Bank	Cash Balance per Book
+ Deposits in Transit	+ Collections & Interest
− Outstanding Checks	− Bank fees and NSF Checks
+/− Bank Errors	+/− Book Errors
Adjusted Cash Balance	Adjusted Cash Balance

Adjusting entries are recorded for the reconciling items on the book side of the reconciliation.

Learning Objective P3: Prepare a bank reconciliation.

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Bank Reconciliation Demonstration: Steps 1-4

Exhibit 8.7

VIDEOBUSTER
Bank Reconciliation
October 31

①	Bank statement balance		$ 2,050	⑤	Book balance		$ 1,405
②	Add			⑥	Add		
	Deposit of Oct. 31 in transit		145		Collected note	$485	
			2,195		Interest earned	8	493
③	Deduct						1,898
	Outstanding checks			⑦	Deduct		
	No. 124	$150			Check printing charge	23	
	No. 126	200	350		NSF check	30	53
④	**Adjusted bank balance**		**$1,845**	⑧	**Adjusted book balance**		**$1,845**

Balances are equal (reconciled)

Learning Objective P3: Prepare a bank reconciliation.

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Bank Reconciliation Demonstration: Steps 5-8

Exhibit 8.7

VIDEOBUSTER
Bank Reconciliation
October 31

①	Bank statement balance		$ 2,050	⑤	Book balance		$ 1,405
②	Add			⑥	Add		
	Deposit of Oct. 31 in transit		145		Collected note	$485	
			2,195		Interest earned	8	493
③	Deduct						1,898
	Outstanding checks			⑦	Deduct		
	No. 124	$150			Check printing charge	23	
	No. 126	200	350		NSF check	30	53
④	**Adjusted bank balance**		**$1,845**	⑧	**Adjusted book balance**		**$1,845**

Balances are equal (reconciled)

Learning Objective P3: Prepare a bank reconciliation.

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Entries from a Bank Reconciliation

Only items reconciling the book balance require adjustment.

Collection of Note

Oct. 31	Cash	485	
	Notes Receivable		485
	Record note collected by bank.		

Interest Earned

Oct. 31	Cash	8	
	Interest Revenue		8
	Record interest earned in checking account.		

Check Printin

Oct. 31	Miscellaneous Expenses	23	
	Cash		23
	Check printing charge.		

NSF Check

Oct. 31	Accounts Receivable—T. Woods	30	
	Cash		30
	Charge Woods's account for $30 NSF check.		

Learning Obje

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Learning Objective A1

Compute the days' sales uncollected ratio and use it to assess liquidity.

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Days' Sales Uncollected

Indicates how much time is likely to pass before we receive cash receipts from credit sales.

Exhibit 8.8

Exhibit 8.9

Company	Figure ($ millions)	Current Year	1 Year Ago	2 Years Ago
Starbucks	Accounts receivable	$ 879	$ 693	$ 870
	Net sales	$26,509	$24,720	$22,387
	Days' sales uncollected	**12.1 days**	**10.2 days**	**14.2 days**
Jack in the Box	Accounts receivable	$ 45	$ 57	$ 60
	Net sales	$ 950	$ 870	$ 1,097

Learning Objective A1: Compute the days' sales uncollected ratio and use it to assess liquidity.

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Learning Objective P4

Appendix 8A

Describe use of documentation and verification to control cash payments.

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Documentation and Verification

Purchase Requisition

Purchase Order

Purchase Order

Receiving Report

Learning Objective P4: Describe use of documentation and verification to control cash payments.

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Invoice Approval

- **Accounting department will record purchase and approve payment after all documents are in order.**
- **Information across all documents are verified.**
- **Invoice approval also called check authorization.**
- **Checklist of steps necessary for approving invoice and payment.**

Learning Objective P4: Describe use of documentation and verification to control cash payments.

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Voucher

- Voucher is complete after invoice has been checked and approved.
- Used to authorize recording obligation.
- Certain information is required on the inside of a voucher.
- Certain information is also required on the outside of a voucher.

Learning Objective P4: Describe use of documentation and verification to control cash payments.

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End of Chapter 8

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